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**Sent:** 12/24/2015 12:52:15 AM  
**To:** Jeffrey Epstein [jeevacation@gmail.com]  
**Subject:** Fwd: Alert: FIRPTA and REIT Reform Provisions in the New Tax Law Open Door to Increased Foreign Investment in U.S. Real Property Interests

**Importance:** High

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**To:** [REDACTED]  
**Subject:** Alert: FIRPTA and REIT Reform Provisions in the New Tax Law Open Door to Increased Foreign Investment in U.S. Real Property Interests  
**Reply-To:** [REDACTED]



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TAX ALERT

DECEMBER 23, 2015

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**FIRPTA and REIT Reform Provisions in  
New Tax Law Open Door to Increased  
Foreign Investment in U.S. Real  
Property Interests**

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On December 18, 2015, President Obama signed into law a bill that significantly reforms the provisions of the Internal Revenue Code that were originally added 35 years ago by the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). The Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") also includes extensions of a number of tax relief provisions that expired at the end of 2015. The PATH Act makes foreign capital investment in U.S. real estate, energy and infrastructure assets more attractive by expanding certain exemptions from FIRPTA and clarifying the application of certain FIRPTA provisions to REITs and their shareholders.

#### **I. FOREIGN PENSION FUNDS EXEMPTED FROM FIRPTA TAXATION**

One of the most significant provisions of the PATH Act is the addition of a complete exemption from FIRPTA for "qualified foreign pension funds" and "entities" wholly owned by such funds, effective on the date of enactment. A foreign pension fund is "qualified" if it is subject to government regulation and certain reporting requirements in its home jurisdiction, is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees, has no greater than 5 percent beneficiaries, and enjoys tax benefits on either contributions or investment income in its home jurisdiction. The new exemption applies to direct investments and investments made through partnerships (including private equity funds). The PATH Act provides for certain details to be addressed by Treasury Regulations. It appears that the "entities" eligible for the FIRPTA exemption could include a U.S. or foreign "blocker" corporation that is wholly owned by a qualifying foreign pension fund. This exemption will, for the first time, permit foreign pension funds, including some governmental funds, to hold control positions in REITs without losing their FIRPTA exemption.

Note that the regular rules of the Internal Revenue Code other than FIRPTA still would apply to the foreign pension fund. Therefore, a foreign pension fund that invested in a partnership that was engaged in a U.S. business (real estate or non-real estate) would still be subject to U.S. federal income tax on its share of the partnership's "effectively connected" U.S. business income in the same manner as other non-U.S. persons making an investment in a U.S. business partnership.

Here are some examples of what can be done in light of the changes made by the PATH Act:

**A. Raw Land Investment.** A qualifying foreign pension fund invests in a partnership that buys raw land in the United States. (This could be a vacant lot, timberland, oil and gas or mineral property, or other property interests that qualify for treatment as real property for federal income tax purposes.) The investment is a capital asset, as the partnership is not engaged in business. The partnership later sells the property to a developer, or the pension fund sells its partnership interest. Under prior law, the foreign pension fund's non-business capital gain would automatically be subject to US federal income tax because of FIRPTA. Under the new law, the foreign pension fund's long-term or short-term capital gain is exempt from U.S. income tax and FIRPTA withholding because FIRPTA does not apply.

**B. Equity Kicker Mortgage Loan Investment.** A foreign pension fund acquires an ownership interest in a mortgage loan secured by U.S. real property. The loan includes stated interest plus an equity kicker (*e.g.*, additional interest equal to a share of gain realized on sale of the property). Such an equity kicker loan is treated as a U.S. real property interest under FIRPTA. Under prior law, gain realized by the foreign pension fund upon sale of the loan would automatically be subject to U.S. income tax under FIRPTA. Under new law, the gain realized on the sale of the mortgage loan would be exempt from U.S. income tax. (This conclusion is based on the assumption that the foreign pension fund is a mere investor and not engaged in an active lending business in the U.S.)

**C. U.S. Blocker Corp. Investment.** A foreign pension fund wants to make an equity investment in a U.S. real estate business that is organized as a partnership. The foreign pension fund forms a U.S. corporation to acquire the partnership interest and the corporation is capitalized with a mix of equity and debt held by the shareholder. The corporation is subject to U.S. income tax on its net income, but gets to deduct interest paid or accrued on the debt held by the shareholder. The foreign corporation later sells the stock of the corporation. Under prior law, the gain on sale of the stock would be subject to U.S. income tax because the corporation was a "U.S. real property holding corporation" under FIRPTA. Under new law, FIRPTA does not apply to the foreign pension fund, so the capital gain on sale of the stock is exempt from U.S. income tax. Note that the U.S.-source interest paid to the foreign shareholder could be subject to U.S. withholding tax under the regular rules of the Code, but if the pension fund is organized in a jurisdiction that has a tax treaty with the U.S. (*e.g.*, UK, Germany, France, China, Japan, etc.), these interest payments could be exempt from U.S. withholding under such tax treaty.

## **2. FIRPTA EXEMPTION FOR INVESTMENTS IN PUBLICLY TRADED REIT STOCK INCREASED FROM 5 PERCENT to 10 PERCENT**

For publicly traded REITs, the PATH Act opens the door to increased investment by expanding the current statutory exemption from FIRPTA for small portfolio investments by non-U.S. persons. The Act provides all foreign investors (not just pension funds) can now own up to 10 percent of the stock of a publicly traded REIT without triggering FIRPTA tax. Under prior law, FIRPTA tax would apply upon the foreign investor's sale of stock of the publicly traded REIT or the receipt of certain distributions from such REIT if the foreign investor holds more than 5 percent of the REIT's stock.

## **3. CLARIFICATION OF THE EXEMPTION FOR INVESTMENTS IN DOMESTICALLY CONTROLLED REITS**

The PATH Act includes important clarifying presumptions that will allow publicly traded REITs and their shareholders to rely with greater confidence on the current law FIRPTA exemption for gains realized on sales of stock in "domestically controlled" REITS. In determining whether a REIT is domestically controlled, the REIT is now permitted to presume that any owner of less than 5 percent of any publicly traded shares of the REIT is a U.S. person, unless the REIT has actual knowledge to the contrary.

## **4. REVENUE RAISING PROVISIONS RELATING TO FIRPTA AND REITs**

The PATH Act includes certain revenue raising provisions to offset, in part, the tax revenue loss anticipated to result of the above-described tax reform provisions of the Act. Such revenue raisers include (among other technical changes) the following provisions:

**A. Increase in FIRPTA Withholding Rate.** The purchaser of a U.S. real property interest from a non-U.S. person was previously required to withhold 10 percent of the purchase price under FIRPTA. The PATH Act increases this rate to 15 percent for dispositions occurring after the 60th day following enactment, but maintains the 10 percent rate for sales of residential property for between \$300,000 and \$1,000,000. This provision is not a tax increase but is designed to ensure that FIRPTA withholding collects a sufficient portion of the taxes owed.

**B. Restriction on REIT Spin-offs.** In recent years, it has become increasingly common for large corporate taxpayers to reduce their tax bills by contributing real estate used in their businesses to a subsidiary, spinning off the subsidiary in a tax free transaction under Code section 355, and then having the spun-out corporation making a REIT election. The PATH Act curtails such activity by (i) providing that neither the distributing corporation nor the spun-out corporation can make a REIT election for ten years after that corporation was involved in a Section 355 transaction and (ii) denying tax-free treatment to spin-offs in which the distributing corporation or spun-out corporation (but not both) is a REIT.

## 5. CONCLUSION

The revisions to the FIRPTA and REIT rules discussed above represent a potentially large expansion of the incentives for foreign investment in U.S. real property interests, especially for foreign pension funds. Sponsors of U.S. real property investment funds and foreign investors with interests in U.S. real estate assets should review the new provisions to determine whether such persons could benefit from such U.S. tax law changes.

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